THE EU TAXONOMY FOR SUSTAINABLE INVESTMENTS – REAL ESTATE

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THE TAXONOMY REGULATION AND ITS OBJECTIVES

Regulation (EU) 2020/852 of the European Parliament and EU Council (the 'Taxonomy Regulation')[1] came into force on 12 July 2020, although it will not start applying until 1 January 2022 at the earliest. It represents a key step towards the EU's objective of achieving a climate neutral union by 2050.

> "The taxonomy is likely to be a key tool in assessing any green supporting factors under banks' prudential rules (e.g. capital adequacy treatment)."

The Taxonomy Regulation provides uniform criteria for companies and investors to determine whether an economic activity is "environmentally sustainable". It is a classification system (known as a "taxonomy") which will help investors identify what is, or is not, sustainable. Its aims include[2]:

- To re-direct capital flows to sustainable investment and to companies engaged in or transitioning to more sustainable activities;
- To limit market fragmentation in the classification of green activities and investment projects, which will in turn facilitate cross-border sustainable investment in the EU;
- To increase transparency thereby enhancing investor confidence and awareness of the environmental impact of financial products/corporate bonds; and
- To create visibility and address concerns about "greenwashing" (that is, the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact, basic environmental standards have not been met).

Further, the taxonomy is likely to be a key tool in assessing any green supporting factors under banks' prudential rules (e.g. capital adequacy treatment). For example, the European Banking Authority has a mandate to assess the need for a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives, which will use the new EU taxonomy[3].

SCOPE OF THE TAXONOMY REGULATION

The Taxonomy Regulation applies to:

- measures adopted by Member States or by the EU that set out requirements for financial market participants ("FMPs") or issuers in respect of financial products (which includes investment funds, pensions and UCITS) or corporate bonds that are made available as environmentally sustainable, for example Green Bonds (FMPs include insurance undertakings, investment firms, pension providers and fund managers);
- FMPs that make available financial products; and
- undertakings which are subject to the obligation to publish a non-financial statement or a consolidated non-financial statement pursuant to the Non-Financial Reporting Directive (see below).

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THE DEFINITION OF "ENVIRONMENTALLY SUSTAINABLE" UNDER THE TAXONOMY

There are **four criteria** under the Taxonomy Regulation which an economic activity must meet in order to qualify as "environmentally sustainable[4]":

1. **Contributes substantially** to one or more of the six environmental objectives	+	**2.** **Does not significantly harm** any of the six environmental objectives	+	**3.** Complies with the **minimum safeguards** (set out in Article 18 of the Taxonomy Regulation)	+	**4.** Complies with the **Technical Screening Criteria ("TSC")** (see below)

As mentioned above, the Taxonomy Regulation sets out **six environmental objectives[5]:**

1. climate change mitigation;
2. climate change adaptation;
3. sustainable use and protection of water and marine resources;
4. transition to a circular economy;
5. pollution prevention and control; and
6. protection and restoration of biodiversity and ecosystems.

Each of the objectives is defined in the Taxonomy Regulation.

TECHNICAL SCREENING CRITERIA: OVERVIEW

The **Technical Screening Criteria** (the "TSC") are uniform criteria which will be used to determine whether economic activities "contribute substantially" to each environmental objective, and therefore can be considered sustainable[6]. The TSC will also determine whether any of those economic activities cause significant harm to any of the other environmental objectives (in accordance with criteria (2) above). The TSC will therefore be used as a basis for establishing an actual list of environmentally sustainable activities and will be implemented pursuant to the Taxonomy Regulation through delegated acts which are to be adopted in two sequences[7].

The draft TSC covers the following 13 sectors:

1) Agriculture and forestry;
2) Environmental protection and restoration activities;
3) Manufacturing;
4) Energy;
5) Water supply, sewerage, waste management and remediation activities;
6) Transport (including maritime);
7) Construction and real estate;
8) Information and communication;
9) Professional scientific and technical activities;
10) Financial and insurance activities;
11) Education;
12) Human health and social work activities; and
13) Arts, entertainment and recreation.

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Work has commenced on elaborating the TSC for the first two environmental objectives (*climate change mitigation and climate change adaptation*). This first delegated act was expected to be adopted by 31 December 2020 with the intention that the taxonomy would **apply from 1 January 2022[8].** However, the regulation is still in draft form and will be adopted as soon as possible after the evaluation of the stakeholder feedback. The feedback period closed on 18 December 2020, so we expect more information from the EU on the timetable for implementation in due course.

For the four other environmental objectives (*water; circular economy; pollution control and biodiversity)*, the taxonomy is intended to be established by the end of 2021 so that the taxonomy can start to apply to those objectives from **1 January 2023**[9]**.** This gives those affected by the Taxonomy Regulation a year to familiarise themselves with the TSC and to prepare for their application[10].

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The annexes to the delegated acts are where the TSC are set out in detail, together with very technical industry specific tests for various sectors and economic activities. Investors will need to use these annexes when determining whether or not the economic activity is sustainable.

The Technical Expert Group (the "TEG") was set up by the Commission to provide technical input and establish the TSC for each environmental objective. The TEG has now been replaced by the Platform on Sustainable Finance (the **"**Platform"), comprising of a broad range of experts from both the public and private sectors, who will be responsible for establishing and updating the TSC going forward[11]. The Platform will therefore develop the TSC for the remaining four environmental objectives.

The Commission will review the TSC, based on the advice it receives from the Platform in line with scientific and technological developments, and where appropriate amend the delegated acts[12]. This means that, in the case of tightening criteria for certain economic activities, it is possible that some activities that were previously considered taxonomy-aligned would lose their eligibility[13]. It is also envisaged that the scope of the taxonomy is extended beyond environmentally sustainable economic activities so that it covers other sustainability objectives, including **social objectives**[14], and criteria for a **"brown" taxonomy**[15]**.**

TECHNICAL SCREENING CRITERIA: CONSTRUCTION AND REAL ESTATE

The building sector is among the largest energy-consuming sectors in the European Union, responsible for 40% of energy consumption and 36% of carbon emissions and can therefore play an important role in climate change mitigation.

The current draft TSC in respect of construction and real estate activities is comprised of seven categories:

- Construction of new buildings;
- Renovation of existing buildings;
- Installation, maintenance and repair of energy efficiency equipment;
- Installation, maintenance and repair of charging stations for electric vehicles in buildings;
- Installation, maintenance and repair of instruments and devices for measuring;
- Installation, maintenance and repair of renewable energy technologies; and
- Acquisition and ownership of buildings.

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For each of these categories the draft TSC sets out criteria concerning the reduction of primary energy demand, the use of sustainable technologies (e.g. lower water usage systems), waste management (with minimum thresholds for recycling of non-hazardous construction and demolition waste), controls around construction materials and the use of hazardous materials and (where relevant) requirements for an environmental impact assessment.

Energy efficiency

The TSC in respect of energy efficiency is particularly challenging in the context of the acquisition and ownership of buildings. For the acquisition of buildings built before 31 December 2020 to meet the criteria, the building must have at least an Energy Performance Certificate (EPC) of class A. For buildings built after 31 December 2020, the building must meet the criteria set out in the relevant TSC for construction of new buildings – this requires an energy performance at least 20% lower than the threshold set of the nearly zero-energy building requirements in national measures implementing the Energy Performance of Buildings Directive[16]. In its response to the consultation on the TSC, the International Capital Markets Association[17] notes that the requirement for acquired buildings built before 31 December 2020 to have an EPC of class A means that "*…in many countries…the buildings that were to qualify under the proposed EPC-A criteria amount to <1% of stock…*" and that there are many differing measures or focusses as to what constitutes a green building. Concerns are that the current draft of the TSC in this regard is too challenging for FMPs looking to issue Green Bonds as most existing Green Bond frameworks would fail to meet the EPC-A criterion.

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DISCLOSURE OBLIGATIONS

The Taxonomy Regulation is closely linked with the Disclosure Regulation (defined below) and the Non-Financial Reporting Directive (the "NFRD") and introduces new disclosure obligations for a range of entities. We set out what this will mean for both reporting companies and FMPs below.

REPORTING COMPANIES

Article 8 of the Taxonomy Regulation requires financial and non-financial organisations covered by the NFRD to include information in their non-financial information statements on how, and to what extent, their business activities (turnover, CapEx and OpEx) align with the Taxonomy Regulation[18]. They will have to start disclosing against the first two climate objectives (*climate change mitigation and climate change adaptation*) in the course of 2022 (covering the financial year 2021) and all six environmental objectives in the course of 2023 (covering the financial year 2022[19]).

Currently the NFRD applies only to EU-incorporated large public interest entities (PIEs), which can include organisations in the financial and non-financial sectors with securities traded on a regulated market, in each case if they have more than 500 employees. However, the Commission has announced a review of the NFRD and one issue being considered is whether it is amended to include all listed companies (including SMEs) and/or set the bar precisely at SMEs level (i.e. above 250 employees)[20].If the scope of the NFRD was extended, this would in turn have a knock-on effect on which organisations need to comply with the disclosure requirements in Article 8 of the Taxonomy Regulation.

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Another important point to note is that that companies within the scope of the NFRD will have to disclose even if there are no specific criteria (yet) available to their activities/sector[21]. The content and presentation of the information to be disclosed under Article 8 will be further specified by the Commission by 1 June 2021 through a delegated act[22].

FINANCIAL MARKET PARTICIPANTS

Articles 5-7 of the Taxonomy Regulation introduce new disclosure requirements for entities covered by EU Regulation 2019/2088 (the "Disclosure Regulation"), which includes insurance undertakings, investment firms, pension providers and fund managers[23]. Such entities will need to disclose how and to what extent their portfolios align with taxonomy objectives. More specifically:

1. **Sustainable products (as defined by Disclosure Regulation):** entities will need to set out the percentage of their portfolio that is EU Taxonomy-aligned[24];
2. **Products with ESG characteristics (as defined by Disclosure Regulation):** as above, entities must set out the percentage of their portfolio that is EU Taxonomy-aligned; and include a statement that the "do no significant harm principle" only applies for the investments underlying the product that consider the EU taxonomy[25]; and
3. **Mandatory statement products with <u>no</u> ESG characteristics:** the following statement must be included in their disclosures: the "product does not consider the EU Taxonomy"[26].

These disclosures will need to be made in a company's pre-contractual documents, websites and periodic reports[27]. The first set of disclosures against the taxonomy, covering activities that substantially contribute to climate change mitigation and adaption, need to be made from 1 January 2022. Disclosures in relation to all six environmental objectives will need to be made from 1 January 2023[28].

EXTRA TERRITORIAL EFFECT

The disclosure obligations for FMPs in the Taxonomy Regulation (as set out above) apply to anyone offering financial products in the EU regardless of where the manufacturer of such products is based. In addition, the disclosure obligations pursuant to Article 8 of the Taxonomy Regulation (as set out above) apply to entities subject to the NFRD and to all their activities regardless of their location[29].

Furthermore, the TEG has suggested that investors in third countries could use the taxonomy criteria to benchmark or compare the environmental performance of local economic activities in those countries. In cases where a locally relevant threshold has been used to assess the environmental performance of an economic activity, it is also suggested by the TEG that companies and investors may wish to provide an additional second disclosure setting out the details and rationale for variation from the TEG standard[30].

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The UK's approach with respect to taxonomy-related disclosures post-Brexit is not yet clear. In June 2020, it was confirmed that the UK would retain the taxonomy framework, including the six environmental objectives. However, as the details are to be set out in the future delegated acts which are not yet finalised, the UK government could not confirm at that stage the extent to which UK law will align with EU law here. In November 2020, the UK announced that a UK taxonomy will take the metrics and thresholds in the EU taxonomy as its basis and then a new UK Green Technical Advisory Group, an equivalent to the TEG, will be established to review these metrics "to ensure they are right for the UK market"[31]. In addition, the UK has published a roadmap towards mandatory climate-related disclosures across the UK economy aligned with the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD)[32]. How the roadmap will align with any UK taxonomy and implementation of the EU taxonomy has yet to be seen and will no doubt impact on, and add complexity to, the disclosure which FMPs are required to make.

> "It is clear that the Commission intends the Taxonomy Regulation to become a benchmark for measuring sustainable investment in a number of ways."

VERIFICATION AND ASSESSMENT OF TAXONOMY ALIGNMENT

The Taxonomy Regulation does not explicitly require any formal verification of whether activities comply with the TSC. However, as set out above, compliance with the taxonomy disclosure obligations will be monitored. In addition, as good practice, FMPs are encouraged to seek external assurance on their taxonomy-related disclosures.

Disclosures made under the NFRD do not, as a baseline, require verification (although this may vary based on the transposition by Member States). However, this may be subject to change depending on the outcome of the currently on-going review of the NFRD[33].

CONCLUSION

The Taxonomy Regulation is likely to have a significant impact on reporting obligations for FMPs and a broad range of other companies, although understanding the level of additional work required will depend on the detailed criteria set out in the TSC. It is clear that the Commission intends the Taxonomy Regulation to become a benchmark for measuring sustainable investment in a number of ways. We therefore suggest that FMPs and other entities follow its evolution closely, and in particular:

- identify any disclosure and data requirements and establish reporting procedures;

- consider the impact of the Taxonomy Regulation on investment and access to financing, particularly as this may enable investors to better target “green” investments; and
- consider their existing compliance with the criteria, and whether/how to take it into account in their future financing decisions.

This is part of a series of articles on the EU Taxonomy. Follow the links to see our guidance on how it affects the transport, energy and mining sectors.

[1] For the text of the Taxonomy Regulation as published in the Official Journal, click here.

[2] Taxonomy Regulation, Recitals 6-14.

[3] Frequently asked questions about the work of the European Commission and the Tecnical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard (the "**TEG FAQs**"), p.8. For the text of the TEG FAQs, click here.

[4] Taxonomy Regulation, Article 3.

[5] Taxonomy Regulation, Article 9.

[6] See requirements as set out in the Taxonomy Regulation, Article 19.

[7] Taxonomy Regulation, Recital 54.

[8] Taxonomy Regulation, Articles 10(6) and 11(6).

[9] Taxonomy Regulation, Articles 12(5), 13(5), 14(5) and 15(5).

[10] Taxonomy Regulation, Recital 57.

[11] Taxonomy Regulation, Article 20 and TEG FAQs, p. 6.

[12] Taxonomy Regulation, Article 19(5).

[13] TEG FAQs, p.7

[14] Taxonomy Regulation, Recital 59.

[15] TEG FAQs, p. 8.

[16] [Directive 2010/31/EU].

[17] ICMA Response to the draft Delegated Act supplementing the EU Taxonomy Regulation (icmagroup.org).

[18] Taxonomy Regulation, Article 8(1) and (2).

[19] Taxonomy Regulation, Article 27(2).

[20] TEG FAQs, p. 16.

[21] TEG FAQs, p.13.

[22] Taxonomy Regulation, Article 8(4).

[23] Disclosure Regulation, Article 2(1). For the text of the Disclosure Regulation as published in the Official Journal, click here.

[24] Taxonomy Regulation, Article 5.

[25] Taxonomy Regulation, Article 6.

[26] Taxonomy Regulation, Article 7.

[27] The TEG Final Report on the EU Taxonomy (the "**TEG Final Report**"), paragraph 3.3.1. For the text of the TEG Final Report, click here.

[28] Taxonomy Regulation, Article 27(2).

[29] TEG FAQs, p. 10.

[30] TEG FAQs, p.18.

[31] Chancellor sets out ambition for future of UK financial services – GOV.UK (www.gov.uk).

[32] FINAL_TCFD_ROADMAP.pdf (publishing.service.gov.uk).

[33] TEG Final Report, paragraph 3.2.8 and TEG FAQs, p.11.

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